

## Manager to launch second China mezzanine fund

By Georgina Lee, 21 September 2012

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**Fund-of-funds manager Gen2 Partners is targeting AUM of \$275 million and an initial close by the end of this year, pointing to an estimated \$500 billion shortfall in SME financing in China.**



Barry Lau is co-founder of Gen2 Partners

Monetary easing by Beijing is not likely to dilute investor interest in providing private finance to the nation's 49 million small and medium-sized enterprises, according to Gen2 Partners.

Barry Lau, co-founder of the fund-of-funds manager, expects the government to continue to focus on preventing asset bubbles, given that inflation remains policymakers' chief concern.

The People's Bank of China has cut interest rates twice so far this year, reducing the one-year lending rate by 170bp. Over the same period the minimum reserve requirement ratio that governs how much banks must hold on deposit with the central bank has been cut three times.

However, China's band of SMEs are falling through the funding cracks despite this policy easing, with Chinese banks preferring to lend to infrastructure projects and state-owned enterprises.

"The tightening of credit [imposed on banks several years ago by the China Banking Regulatory Commission] appeared to be cyclical and sector-driven, while today various curbs and prudential measures are targeted at containing real estate bubbles," he reflects.

"So you can expect such measures to be shifted to target other sectors, including mining or technology, as soon as there are signs that inflationary pressures are building in any of these."

Lau argues that the state-controlled nature of China's economy has given sponsors of mezzanine financing more latitude to target investment opportunities.

Riding on what he estimates as a \$500 billion funding gap in the SME segment, Gen2 Partners has launched a second China-focused mezzanine PE fund – Gen2 Capital Partners Fund II – and is targeting an initial close by end of this year.

**Its first China-focused mezz fund was launched in 2010.** Lau says 60% of the fund's invested capital has either been fully or partially repaid by borrowers, with the remaining 40% outstanding due partly to borrowers not having reached their repayment deadlines.

The five investors in the first fund have each received a minimum 8% annual cash distribution out of the fund's income, proportionate to their respective capital contributions. The fund achieved an internal rate of return of around 30%, says Lau.

For the second fund Lau's team is targeting mezz financing investments to 20 SMEs, for projects ranging from \$5 million to \$20 million. The target AUM for the new fund is \$275 million, locking investors up for its entire seven-year tenor.

"While for the first mezzanine fund we used a hybrid structure – investors were given annual liquidity after a two-year lock up – we learned a lesson that it is generally difficult to run private equity in a hedge-fund like format," notes Lau.

He adds: "Due to the one-year liquidity term, some investors told us that our fund's liquidity profile did not fit into either their private equity or hedge fund mandate."

As a result, rather than marketing to hedge fund investors, his team, with co-founder and CEO Paul Heffner, opted to use a PE structure. During the first five years investors will see principal reinvested and distributed only out of investments generating current income.

The fund will focus on opportunities in the pharmaceutical, eco-tourism and resources sectors, differing from the first fund which invested in mining operators and property developers.

Lau points out that SMEs in China are devoid of senior creditors in their capital structure. This makes mezz financing an attractive fallback option for them, with Gen2 typically charging 25% interest per year for an investment of between six months to three years, before exiting.

But Lau concedes the new fund may be vulnerable to a shift in macroeconomic policy as China transitions to new leadership, with president in-waiting Xi Jinping set to take the reins from incumbent Hu Jintao.